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Auf Wiedersehen to the tax privilege on restructuring gains – a blow to the German restructuring tool kit

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Authors: Bodo Bender, Riaz Janjuah, Tom Schorling

A recent judgment of the German Federal Fiscal Court (FFC) will have significant impact on the restructuring tool kit afforded under German law. The FFC has found that the existing practice of permitting a tax liability arising from restructuring gains to be deferred and (eventually) waived violates fundamental principles of German law. The ruling has created uncertainty regarding the proper tax treatment of restructuring gains, which may have the effect of diminishing the prospect of success of a restructuring for a company in financial distress.

This article explains the FFC's main arguments and offers a first assessment of the implications of the FFC's decision.

A Decision of Fundamental Impact on Future Corporate Restructurings

A partial or complete waiver of debt is often at the heart of a financial restructuring plan. The waiver of debt by a creditor as part of a restructuring causes the debtor (the restructured company) to realise a taxable "gain" because liabilities of the debtor are reduced without corresponding consideration payable by the debtor. A specific tax exemption provision in force in respect of such gains was abolished in 1998.

In its February 2017 ruling, the FFC found that when, the legislature repealed the previous tax exemption of the German Income Tax Act in 1997 it clearly expressed its intention that restructuring gains should no longer be subject to preferential tax treatment. Therefore, restructuring gains must be subject to the same tax treatment as all other gains recognised in relation to any settlement of debts.

According to the FFC's, when the German Federal Ministry of Finance (FMF) issued its guidance on a reorganisation tax privilege (Reorganization Decree (*Sanierungserlass*)) in 2003 it acted in a legislative capacity, which was beyond its authority. The FFC argued that by reintroducing the preferential tax treatment of restructuring gains (even if slightly modified) to solve the dilemma of conflicting aims of tax legislation and the Insolvency Statute, the FMF effected a structural adjustment of tax law. The regulations waiving payment of tax in specific sets of circumstances identified in the Reorganization Decree went beyond the equitable remedies permitted to be applied on a case-by-case basis under the German Fiscal Code (*Abgabenordnung*, "AO"). Therefore FFC found that the Reorganization Decree violated the principle of legality laid down in the German constitution and the Fiscal Code.

In the FFC's view, the conditions set down in the Reorganization Decree for obtaining preferential tax treatment of restructuring gains on grounds of fairness do not fall within the definition of substantive unfairness (*sachliche Unbilligkeit*) identified the sections of the AO which permit equitable waivers of tax payment.

The FFC found that, restructuring gains from cash-neutral waiver of debt are not atypical isolated cases justifying a waiver on grounds of substantive unfairness. Instead, any waiver of debt in the context of restructuring increases a company's profitability and must therefore be recognised as operating income. The FFC believe that any reasons based on economic, labour, social or cultural policy used to justify the equitable waiver of tax payment are irrelevant and cannot justify granting the waiver.

The FFC also said that no substantive unfairness existed simply because the financial headroom created by the waiver of debt was subsequently reduced by the tax liability arising on the restructuring gain. Therefore, the tax liability did not hit the company at the wrong time. It held that the decision on whether there were any of the objective reasons for a waiver on equitable grounds had to be made irrespective of the company's specific economic situation.

The FFC clarified that unless a case falls within the definition of substantive unfairness under the AO the FMF cannot create a basis for granting a waiver of tax payment. As a result, new claims for preferential tax treatment based on the Reorganization Decree will have little prospect of success.

What does this mean for restructurings in Germany?

The decision creates uncertainty for current and future restructurings. The tax authorities have indicated that they will no longer apply the principles of the Reorganization Decree and will not grant binding rulings on the tax treatment of restructuring gains until a revised law has been enacted. For the time being it is expected that waivers in relation to tax payments arising on restructuring gains may only be granted in exceptional cases in which taxation would lead to substantive or personal unfairness on the company.

The FFC did not make any statements on cases where tax waivers have already been given based on the Reorganization Decree or binding rulings that has already been given and implemented. Therefore, completed proceedings as well as tax rulings already given are expected to remain unaffected by the FFC's decision.

What next?

The Reorganization Decree provided a foundation for the tax treatment of restructuring gains and reliable preferential taxation of restructuring gains and is indispensable for companies in distress. As the FFC was adamant that preferential tax treatment could only be introduced by the legislature, the legislature must act quickly, or numerous restructurings may fail. Tax authorities recently announced to put forward a legislative proposal implementing, broadly speaking, the main principles of the Reorganization Decree into the German tax codes. The goal is to complete such legislative procedure in the first half of 2017, but in any case before the German elections taking place in September 2017. The new law shall apply retroactively to all open cases.

For the time being until the legislator may introduce a reliable legal basis for restructurings, we recommend exploring alternative reorganisation plans that may avoid restructuring gains arising in Germany. Possible alternatives might be "debt-to equity swaps" and "debt-push-up" structures (or a combination of both) or a shift of the company's centre of main interests away from Germany, to transfer restructuring gains to jurisdictions which offer more flexible and reliable tax treatment of restructuring gains. Each case will need comprehensive and careful analysis.

White & Case LLP
John F. Kennedy-Haus
Rahel Hirsch-Straße 10
10557 Berlin
Germany

T +49 30 880911 0

White & Case LLP
Graf-Adolf-Platz 15
40213 Düsseldorf
Germany

T +49 211 49195 0

White & Case LLP
Bockenheimer Landstraße 20
60323 Frankfurt am Main
Germany

T +49 69 29994 0

White & Case LLP
Valentinskamp 70 / EMPORIO
20355 Hamburg
Germany

T +49 40 35005 0